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**AUDITOR-GENERAL
SOUTH AFRICA**

Auditor's report

Naledi Local Municipality

30 June 2014

REPORT OF THE AUDITOR-GENERAL TO THE FREE STATE LEGISLATURE AND THE COUNCIL ON THE NALEDI LOCAL MUNICIPALITY

REPORT ON THE FINANCIAL STATEMENTS

Introduction

1. I have audited the financial statements of the Naledi Local Municipality set out on pages ... to ... which comprise the statement of financial position as at 30 June 2014, the statement of financial performance, statement of changes in net assets, cash flow statement, statement of comparison of budget and actual amounts and the appropriation statement for the year then ended, as well as the notes, comprising a summary of significant accounting policies and other explanatory information.

Accounting officer's responsibility for the financial statements

2. The accounting officer is responsible for the preparation and fair presentation of the financial statements in accordance with South African Standards of Generally Recognised Accounting Practice (SA Standards of GRAP) and the requirements of the Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA) and the Division of Revenue Act of South Africa, 2013 (Act No. 2 of 2013) (DoRA) and for such internal control as the accounting officer determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor-General's responsibility

3. My responsibility is to express an opinion on the financial statements based on my audit. I conducted my audit in accordance with the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA), the general notice issued in terms thereof and International Standards on Auditing. Those standards require that I comply with ethical requirements, and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.
4. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.
5. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified audit opinion

Basis for qualified opinion

Receivables from exchange transactions

6. I was unable to obtain sufficient appropriate audit evidence regarding receivables from exchange transactions due to inadequate management of consumer debtors contained in the financial system. I was unable to confirm the receivables by alternative means. Consequently, I was unable to determine whether any adjustment relating to the gross receivables from exchange transactions stated at R41 113 740 (2013: R31 397 917) in note 6 to the financial statements and stated at R2 356 746 (2013: R12 517 809) in the statement of financial position, was necessary. During 2013, the municipality also did not accurately account for consumer debtors, resulting in an understatement of receivables-

and revenue from exchange transactions by R2 866 735. Additionally, there was a resultant impact on the surplus for the 2013 period, the accumulated surplus.

Consumer receivables from non-exchange transactions

7. I was unable to obtain sufficient appropriate audit evidence regarding consumer receivables from non-exchange transactions due to inadequate management of consumer debtors contained in the financial system. I was unable to confirm the receivables by alternative means. Consequently, I was unable to determine whether any adjustment relating to the gross consumer receivables from non-exchange transactions stated at R8 542 408 (2013: R7 554 541) in note 4 to the financial statements and stated at R1 059 773 (2013: R3 603 621) in the statement of financial position, was necessary.

Service charges

8. I was unable to obtain sufficient appropriate audit evidence regarding the sale of water included in service charges due to inadequate capturing of consumption information on the financial system. I was unable to confirm the sale of water by alternative means. Consequently, I was unable to determine whether any adjustment relating to sale of water stated at R6 062 691 (2013: R6 398 297) in note 19 to the financial statements was necessary. During 2013, the municipality did not have adequate systems and controls in place to account for revenue from exchange transactions, which resulted in an overstatement of service charges by R924 194. Additionally, there was a resultant impact on the surplus for the 2013 period and the accumulated surplus.

Unauthorised expenditure

9. I was unable to obtain sufficient appropriate audit evidence regarding the opening balance and consequently on the closing balance of unauthorised expenditure due to the lack of evidence to support the unauthorised expenditure transactions incurred during the years preceding the 2012-13 financial year. I was unable to confirm the unauthorised expenditure by alternative means. Consequently, I was unable to determine whether any adjustment relating to unauthorised expenditure stated at R102 868 462 (2013: R69 714 462) in note 45 to the financial statements was necessary.

Fruitless and wasteful expenditure

10. The municipality did not include particulars of all fruitless and wasteful expenditure in the notes to the financial statements as required by section 125(2)(d)(i) of the MFMA. The municipality's internal controls and procedures were not sufficient to ensure accurate and complete recording of fruitless and wasteful during the years preceding the 2012-13 financial year. I was unable to determine the full amount of the misstatement as it was impracticable to do so.

Irregular expenditure

11. The municipality did not include particulars of all irregular expenditure in the notes to the financial statements as required by section 125(2)(d)(i) of the MFMA. The municipality made payments in the prior financial years in contravention of the supply chain management requirements. I was unable to determine the full amount of the misstatement as it was impracticable to do so. This had a resultant impact on the current year closing balance of irregular expenditure.

Property rates

12. During 2013, the municipality did not have adequate systems and controls in place to account for revenue from property rates, which resulted in an understatement of property rates and receivables from non-exchange transactions by R546 103, respectively. There was also a resultant impact on the surplus for the 2013 period and the accumulated surplus. In addition, I was unable to obtain sufficient appropriate audit evidence regarding property rates relating to 2013 and to confirm the revenue by alternative means. Consequently I was unable to determine whether any adjustments relating to property rates stated at R6 573 598 in note 20 to the financial statements were necessary. My opinion of the financial statements for the period ended 30 June 2013 was modified accordingly. My opinion on the current period's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures.

Expenditure

13. During 2013, the municipality did not have adequate systems in place to account for expenditure, which resulted in bulk purchases being overstated by R2 719 758 and general expenditure being understated by R918 463, respectively. There was also a resultant impact on the surplus for the 2013 period and the accumulated surplus. In addition, I was unable to obtain sufficient appropriate audit evidence regarding repairs and maintenance, bulk purchases as well as general expenses relating to 2013 and to confirm these amounts disclosed by alternative means. Consequently I was unable to determine whether any adjustments relating to repairs and maintenance, bulk purchases and general expenses stated at R3 031 844, R20 261 829 and R15 343 638 respectively in the statement of financial performance and notes 31, 32 and 33 to the financial statements were necessary. My opinion on the financial statements for the period ended 30 June 2013 was modified accordingly. My opinion on the current period's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures.

Employee related costs

14. During 2013, the municipality did not have adequate systems in place to account for employee related cost, which resulted in an understatement of employee related cost by R457 165. In addition, I was unable to obtain sufficient appropriate audit evidence regarding employee related costs relating to 2013 and to confirm employee cost by alternative means. Consequently, I was unable to determine whether any further adjustments relating to employee related costs stated at R23 706 984 in note 26 to the financial statements were necessary. My opinion of the financial statements for the period ended 30 June 2013 was modified accordingly. My opinion on the current period's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures.

Other income

15. During 2013, the municipality did not have adequate systems and controls in place to account for revenue from exchange transactions, which resulted in an overstatement of other income by R1 410 241. Additionally, there was a resultant impact on the surplus for the 2013 period and the accumulated surplus. My opinion on the financial statements for the period ended 30 June 2013 was modified accordingly. My opinion on the current period's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures.

Aggregation of immaterial uncorrected misstatements

16. The financial statements were materially misstated due to the cumulative effect of numerous individually immaterial uncorrected misstatements in the following items making up the statement of financial position, the statement of financial performance and the notes to the financial statements:

- Grants and subsidies for 2013 understated by R745 614.

In addition, I was unable to obtain sufficient appropriate audit evidence and to confirm the following items by alternative means.

- VAT receivable of R1 208 717 (2013: R593 550) as stated in note 5 to the financial statements.

As a result, I was unable to determine whether any further adjustments to these items were necessary.

Qualified opinion

17. In my opinion, except for the possible effects of the matters described in the basis for qualified opinion paragraphs, the financial statements present fairly, in all material respects, the financial position of the Naledi Local Municipality as at 30 June 2014 and its financial performance and cash flows for the year then ended, in accordance with the SA Standards of GRAP and the requirements of the MFMA and DoRA.

Emphasis of matters

18. I draw attention to the matters below. My opinion is not modified in respect of these matters:

Restatement of corresponding figures

19. As disclosed in note 41 to the financial statements, the corresponding figures for 30 June 2013 have been restated as a result of errors discovered during 2014 in the financial statements of the Naledi Local Municipality at, and for the year ended, 30 June 2013.

Material impairments

20. As disclosed in notes 4 and 6 to the financial statements, a provision for impairment of receivables amounting to R46 239 629 (2013: R22 831 028) has been made with regards to consumer debts amounting to R49 656 148 (2013: R38 952 458).

Material losses

21. As disclosed in note 32 to the financial statements, material losses to the amount of R9 902 571 (2013: R17 832 475) were incurred as a result of distribution losses incurred on water and electricity purchases.

Significant uncertainties

22. With reference to note 39 to the financial statements, the municipality is the defendant in various lawsuits. The municipality is opposing these claims. The ultimate outcome of these matters cannot presently be determined and no provision for any liability that may result has been made in the financial statements.

Going concern

23. Note 43 to the financial statements indicates that, as at 30 June 2014, the municipality's current liabilities exceeded its current assets. This condition, along with other matters as set forth in note 43, indicate the existence of a material uncertainty that may cast significant doubt on the municipality's ability to operate as a going concern.

Additional matter

24. I draw attention to the matter below. My opinion is not modified in respect of this matter.

Unaudited disclosure notes

25. In terms of section 125(2)(e) of the MFMA the municipality is required to disclose particulars of non-compliance with the MFMA. This disclosure requirement did not form part of the audit of the financial statements and accordingly I do not express an opinion thereon.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

26. In accordance with the PAA and the general notice issued in terms thereof, I report the following findings on the reported performance information against predetermined objectives for selected development objectives presented in the annual performance report, non-compliance with legislation as well as internal control. The objective of my tests was to identify reportable findings as described under each subheading but not to gather evidence to express assurance on these matters. Accordingly, I do not express an opinion or conclusion on these matters.

Predetermined objectives

27. I performed procedures to obtain evidence about the usefulness and reliability of the reported performance information for the following selected objective presented in the annual performance report of the municipality for the year ended 30 June 2014:

- Development objective 1: Basic Services on pages XX to XX

28. I evaluated the reported performance information against the overall criteria of usefulness and reliability.

29. I evaluated the usefulness of the reported performance information to determine whether it was presented in accordance with the National Treasury's annual reporting principles and whether the reported performance was consistent with the planned objectives. I further performed tests to determine whether indicators and targets were well defined, verifiable, specific, measurable, time bound and relevant, as required by the National Treasury's *Framework for managing programme performance information* (FMPPI).

30. I assessed the reliability of the reported performance information to determine whether it was valid, accurate and complete.

31. The material findings in respect of the selected objective are as follows:

Development objective 1: Basic Services

Usefulness of reported performance information

32. Section 41(c) of the Municipal Systems Act of South Africa, 2000 (Act No. 32 of 2000) (MSA) requires the integrated development plan (IDP) to form the basis for the annual report, therefore requiring consistency of objectives, indicators and targets between planning and reporting documents. A total of 29% of the reported objectives and 25% of the reported indicators and targets were not consistent with those in the approved IDP. This was because management was aware of the requirements of the FMPPI but chose not to apply the principles contained in the FMPPI.

33. The FMPPI requires that performance indicators must be verifiable, meaning that it must be possible to validate the processes and systems that produced the indicator. The verifiability of planned targets and indicators could not be assessed due to a lack of proper systems and processes and formal standard operating procedures.

Reliability of reported performance information

34. The FMPPI requires auditees to have appropriate systems to collect, collate, verify and store performance information to ensure valid, accurate and complete reporting of actual achievements against planned objectives, indicators and targets. I was unable to obtain the information and explanations I considered necessary to satisfy myself as to the reliability of the reported performance information. This was due to limitations placed on the scope of my work due the fact that the auditee could not provide sufficient appropriate evidence in support of the reported performance information.

Additional matter

35. I draw attention to the following matter:

Achievement of planned targets

36. Refer to the annual performance report on pages XX to XX for information on the achievement of the planned targets for the year. This information should be considered in the context of the material findings on the usefulness and reliability of the reported performance information for the selected objectives reported in paragraphs 32 to 34 of this report.

Compliance with legislation

37. I performed procedures to obtain evidence that the municipality had complied with applicable legislation regarding financial matters, financial management and other related matters. My findings on material non-compliance with specific matters in key legislation, as set out in the general notice issued in terms of the PAA, are as follows:

Budget

38. Expenditure was incurred in excess of the limits of the amounts provided for in the votes of the approved budget, in contravention of section 15 of the MFMA.

Strategic planning and performance management

39. The municipality did not establish a performance management system, as required by section 38(a) of the MSA.
40. The annual performance agreements for the municipal manager and all senior managers were not linked to the measurable performance objectives approved with the budget and to the service delivery budget implementation plan as required in terms of section 53(1)(c)(iii) of the MFMA and section 57(1)(b) of the MSA.
41. The annual performance report for the year under review did not include measures taken to improve performance, as required by section 46(1)(c) of the MSA.
42. The performance management system and related controls were not in place as it did not describe and represent the processes of performance measurement, review, reporting and improvement and how it is conducted, organised and managed, including determining the roles of the different role-players, as required by sections 38 of the MSA and regulation 7 of the *Municipal planning and performance management regulations*.

Audit Committee

43. The audit committee was not constituted, in the manner required by section 166(4)(a) of the MFMA as the following requirement was not adhered to:
- The audit committee did not consist of at least three members for the entire year under review.
44. The audit committee did not meet at least four times a year, as required by section 166(4)(b) of the MFMA.

Revenue management

45. A credit control and debt collection policy was not implemented, as required by section 96(b) of the MSA and section 62(1)(f)(iii) of MFMA.
46. Interest was not charged on all accounts in arrears, as required by section 64(2)(g) of the MFMA. (Ex. 6)

Annual financial statements

47. The financial statements submitted for auditing were not prepared in all material respects in accordance with the requirements of section 122 of the MFMA. Material misstatements of non-current assets, current assets, current liabilities, revenue, expenditure and disclosure items identified by the auditors in the submitted financial statements were subsequently corrected and the supporting records were provided subsequently, but the supporting records that could not be provided resulted in the financial statements receiving a qualified audit opinion.

Expenditure management

48. Money owed by the municipality was not always paid within 30 days, as required by section 65(2)(e) of the MFMA.
49. Reasonable steps were not taken to prevent unauthorised, irregular and fruitless and wasteful expenditure, as required by section 62(1)(d) of the MFMA.

Asset management

50. An adequate management, accounting and information system which accounts for assets was not in place, as required by section 63(2)(a) of the MFMA.

Liability management

51. An effective system of internal control for liabilities including a liability register was not in place, as required by section 63(2)(c) of the MFMA.

Consequences management

52. Unauthorised, irregular, and fruitless and wasteful expenditure incurred by the municipality was not investigated to determine if any person is liable for the expenditure, in accordance with the requirements of section 32(2)(a)(ii) of the MFMA.

Human resource management

53. The municipality did not submit a report on compliance with prescribed competency levels to the National Treasury and relevant provincial treasury as required by regulation 14(2)(a) of the *Regulations on minimum competency levels*.
54. The annual report of the municipality did not reflect information on compliance with prescribed minimum competencies as required by regulation 14(2)(b) of the *Regulations on minimum competency levels*.

Procurement and contract management

55. Bid specifications were not always drafted by bid specification committees which were composed of one or more officials of the municipality as required by Supply Chain Management (SCM) regulation 27(3).
56. Bid adjudication was not always done by committees which were composed in accordance with SCM regulation 29(2).
57. Contracts were awarded to bidders based on preference points that were not calculated in accordance with the requirements of the Preferential Procurement Policy Framework Act of South Africa, 2000 (Act No. 5 of 2000) (PPPFA) and its regulations.
58. Contracts were awarded to bidders that did not score the highest points in the evaluation process, as required by section 2(1)(f) of PPPFA.
59. The performance of contractors or providers was not monitored on a monthly basis, as required by section 116(2)(b) of the MFMA.

Environmental management

60. The municipality operated three waste disposal sites with a waste management license or permit, in contravention of section 20(b) of the National Environmental Management: Waste Act of South Africa, 2008 (Act No. 59 of 2008).

Internal control

61. I considered internal control relevant to my audit of the financial statements, annual performance information report and compliance with legislation. The matters reported below are limited to the significant internal control deficiencies that resulted in the basis for qualified opinion, the findings on the annual performance report and the findings on non-compliance with legislation included in this report.

Leadership

62. There was a slow response to the message communicated by the Auditor-General to leadership. This resulted in many significant matters in the action plan only being implemented in the final part of the year. This also resulted in a lack of adequate processes and controls that ensure the reliability and validity of financial and performance information and compliance with legislation.
63. Some critical vacancies also existed during the year which impacted on the implementation of effective internal controls and the action plan.

Financial and performance reporting

64. Due to a slow response by management to hold staff accountable, various daily and monthly controls and reconciliations were not performed during the year.
65. A history of lack of consequences also resulted in weak measures to monitor compliance with legislation resulting in non-compliance re-occurring that could have been prevented.
66. A lack of competencies was identified, especially in the SCM unit, contributing to the occurrence of irregular expenditure. This also resulted in regular and accurate financial and performance reports not being compiled.

Governance

67. The audit committee was shared between various municipalities and this municipality was unable to ensure that it was sufficient capacitated and that it promoted accountability and service delivery by evaluating and monitoring responses to risks and providing oversight of the effectiveness of the internal control environment.
68. The internal audit unit was not adequately capacitated and functioning and therefore the internal audit unit did not assist management in evaluating internal controls to determine the effectiveness and efficiency thereof.

Auditor-General

Bloemfontein

30 November 2014



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